SYSTEMS OF ACCOUNTING AND SOME BASIC TERMINOLOGIES

Learning Objective

After studying this lecture, the students should be able to:

• Distinguish between Cash Accounting and Accrual Accounting;
• Understand what is
  o Income
  o Expenses
  o Profit or Net Profit
• Distinguish between Cash in Hand and Profit.
• Distinguish between Capital Expenses and Revenue Expenses; and
• Understand what is Liability?

Cash Accounting and Accrual Accounting

Cash Accounting

It is the accounting system in which events are recorded when actual cash / cheque is received or paid.

Let’s take the example of utility bills like electricity, telephone etc. The bill of January is received on 15th February and paid on 25th February. If the organization is following cash accounting practice it will record the expense of electricity / telephone on 25th February because the actual payment is made on that day. The same principle applies for income and other transactions as well i.e. income is recorded when cash is actually received instead recording when it is earned.

Accrual Accounting

It is the accounting system in which events are recorded as and when they occur.

This means that income is recorded when it is earned and expense is recorded when incurred i.e. the organization has obtained the benefit from it. Consider the above example. The electricity is utilized in the month of January so the expense should be recorded in the month of January. Similarly the company that is providing the electricity should record the income in the month of January.

Income

Income is the value of goods or services that a business charges from its customers.

Businesses can be distributed in two major categories. One that provides / sells goods and the other that provides services. If the organization is commercial then these goods or services will always be provided at some price. This price at which these goods / services are provided is the income of the organization, providing the goods / services.
Expenses are the **costs incurred to earn revenue**.

In order to earn revenue, one has to spend some money such as the cost of goods that are sold or the money paid to the individuals who are providing services plus other costs. These costs that are incurred/spent by the business to earn the revenue are the expenses of the business.

**Profit or Net Profit**

Net income or Net Profit is the amount by which the income exceeds expenses in a specific time period.

**OR**

Profit is what is left of the income after all expenses (paid and incurred) have been deducted from it.

\[
\text{Net Profit} = \text{Income} - \text{Expenses}
\]

**Cash in Hand and Profit**

We have said that profit is what is left of income after deducting the expenses. Is it the income received in cash less the expenses paid in cash? Or do we have to consider other things as well? It can be explained with the help of following example.

A trader purchases some goods from a supplier for Rs. 1,500 and promises to pay in two weeks time. (Remember credit transactions from lecture 02). The same day he sells these to a customer for Rs. 2,000 who pays Rs. 1,000 and promises to pay the balance amount after one week. Now at the end of the day, the trader has Rs. 1,000 in his hand. After one week, he will have another Rs. 1,000 and he will pay Rs. 1,500 after two weeks.

What is profit? Is Rs. 1,000 that he has in his hand on day one is his profit.

The answer is **No**. He still has to receive Rs. 1,000 and pay Rs. 1,500 to the supplier plus any other expenses that he may have incurred in the process of this trade. His actual profit is Rs. 500 less any other expenses that he incurs, which is the difference of the total amount that he receives from customer and the amount that he pays to the supplier less other expenses.

What we understand from this example is that cash in hand is not always the profit. To work out the profit we have to consider the total income and total expenses irrespective of the fact that actual payment has been made or not.

**Capital and Revenue Expenses**

We have established, to calculate the profit, all expenses are deducted from income. Are all payments that we make are expenses and have to be deducted from the income? Consider the different types of payments that could be made by a business organization. The payments could be for utility bills, salaries, fuel bills or purchase of vehicle, furniture etc. Out of the types discussed above utility bills, salaries and fuel bill are the payments for which the organisation has already enjoyed the benefit. Whereas vehicle and furniture are the types from which the company will derive the benefit for a long time. If the payment made for vehicles and furniture is subtracted from the income of the period in which payment was made, the
profit for that period will be too low. Whereas, in the future period when the item will still be providing benefit to the company there will be no expense to match the benefit of that expense. This means that we have to distinguish between the payments / expenses that provide benefit to the company immediately and those that last for a longer period.

In accounting the expenses that provide benefit immediately are called “Revenue Expenses” and those expenses whose benefit last for a longer period are called “Capital Expenses”.

Liabilities

Liabilities are the debts and obligations of the business.

Liability is the obligation of the business to provide a benefit or asset on a future date. We have discussed credit transactions. Whenever a person purchases something on credit he promises to pay for the goods on a future date. This is his obligation to pay cash at a future date and thus it becomes his liability.